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No. 97-845

In the Supreme Court of the United States

OCTOBER TERM 1997

LEW WARDEN AND NADJA J. WARDEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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12 pp

QUESTION PRESENTED

Whether expenses incurred in owning and operating a yacht that is used primarily for personal pleasure rather than to generate a profit may be deducted under Section 162 or 212 of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3-11) is reported unofficially at 79 A.F.T.R.2d 97-2168. The opinion of the Tax Court (Pet. App. 12-38) is reported unofficially at RIA T.C. Memo ¶ 95,176.

JURISDICTION

The judgment of the court of appeals was entered on April 2, 1997. The petition for rehearing was denied on August 20, 1997. The petition for a writ of certiorari was filed on November 18, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners claimed depreciation and operating expense deductions in 1989 in connection with their ownership of a yacht. The Commissioner concluded

that, although the yacht was sometimes chartered, petitioners did not operate the yacht with the primary objective of deriving a profit. The Commissioner therefore disallowed the claimed deductions to the extent that they exceeded the gross income received from the charters.

Petitioners sought review of the asserted deficiency in the Tax Court. The Tax Court upheld the Commissioner's determination. The court rejected petitioners' assertion that they needed to prove only a good-faith profit motive to be entitled to the contested deductions. The court noted that "[t]he primary purpose standard" has been consistently followed in the Ninth Circuit, to which appeal lies in this case (Pet. App. 27). The court concluded that, although there were "some manifestations of a business" in petitioners' activities (*id.* at 29), the evidence was more consistent with the conclusion that petitioners neither acquired nor operated the yacht primarily for profit. Instead, it appeared that petitioners "wished to retire from the practice of law, had a desire to sail, had the financial resources to pursue that desire, and had some hope that they could combine their dream retirement with an income-producing venture" (*id.* at 34).

2. The court of appeals affirmed (Pet. App. 3-11). The court held that the Tax Court had correctly applied the primary purpose test to the facts of this case (*id.* at 9-11). The court further stated that it is well-established in the Ninth Circuit that a taxpayer must prove a primary profit motive to be entitled to business expense deductions, and that its "holdings in this area are in line with those of the Supreme Court" (*id.* at 5, citing *Commissioner* v. *Groetzinger*, 480

U.S. 23, 25 (1987), and *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n. 1 (1986)).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 162 of the Internal Revenue Code authorizes the deduction of all ordinary and necessary expenses paid or incurred in carrying on a trade or business. 26 U.S.C. 162. Section 212 of the Code authorizes the deduction of all the ordinary and necessary expenses paid or incurred for the production of income or for the management, conservation, or maintenance of property held for the production of income. 26 U.S.C. 212. In *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987) (emphasis added), this Court explained that "to be engaged in a trade or business * * * the taxpayer's *primary* purpose for engaging in the activity must be for income or profit." Similarly, in *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (emphasis added), the Court stated that "[t]he standard test for the existence of a trade or business for purposes of Section 162 is whether the activity was entered into with the *dominant* hope and intent of realizing a profit" (internal quotations omitted).[1]

Section 183(a) of the Internal Revenue Code expressly precludes the deduction by individuals of expenses incurred in an activity "not engaged in for

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[1] In *United States* v. *Gilmore*, 372 U.S. 39, 45 (1963), the Court explained that deductions under (what is now) Section 212 are "subject to the same limitations and restrictions that are applicable to those allowable under" (what is now) Section 162.

profit" (26 U.S.C. 183(a)). The statute defines an activity "not engaged in for profit" as any activity "other than one with respect to which deductions are allowable" under Sections 162 or 212. 26 U.S.C. 183(c). For activities "not engaged in for profit," Section 183(b) permits deductions only to the extent of the gross income derived from that activity. 26 U.S.C. 183(b).

The decision of the court of appeals correctly implements this statutory scheme. The Tax Court found, as a matter of fact (Pet. App. 34), that the taxpayer's activities were not for the "primary purpose [of] * * * profit" (*Commissioner* v. *Groetzinger*, 480 U.S. at 35) and that deductions were therefore not permitted under Sections 162 or 212. The Tax Court then properly allowed the taxpayer to claim the deductions only to the extent of the income derived from the activity under Section 183(b). There is thus no basis for petitioners' contention (Pet. 3, 17-18) that the decision in this case conflicts with the decisions of this Court in *Commissioner* v. *Groetzinger*, *supra*, and *United States* v. *American Bar Endowment*, *supra*. Indeed, the court of appeals expressly relied on those decisions in its opinion in this case (Pet. App. 5).

2. Petitioners also err in contending (Pet. 18-20) that the decision in this case conflicts with the decision of this Court in *Commissioner* v. *Soliman*, 506 U.S. 168 (1993). In *Soliman*, this Court did not address whether a primary profit motive is required to permit a deduction under Sections 162 or 212. Instead, the Court addressed the circumstances under which the home of a taxpayer qualifies as his "principal place of business" for purposes of the home office deduction permitted under Section 280A(c)(1)(A) of the Code. 506 U.S. at 174-175. The decision in *Soli-*

man dealt with the specifics of the "home office" deduction statute; it did not determine or alter the "primary purpose" test under Sections 162 and 212.

In any event, the legal test that petitioner advocates is not materially different from the test actually applied in the courts below. Petitioner argues that, in determining the availability of business deductions, courts should compare the profit motive to "the other purposes which motivated the taxpayer to enter into or continue a questioned activity" (Pet. 19). That is exactly what the Tax Court did in this case. The court found that petitioners "clearly enjoyed sailing and had engaged in sailing activities for recreation for at least 20 years" (Pet. App. 32), used the yacht "for activities unrelated to chartering" (*ibid.*) and "had a desire to sail" (*id.* at 34). The record thus amply supports the court's conclusion that petitioners were motivated primarily by personal pleasure and not primarily by profit.

3. Petitioners further err in contending (Pet. 2, 7-12) that the decision in this case conflicts with the decisions of other circuits. The cases that petitioners cite do not involve a comparison of profit motive to other motives because there was either (i) no profit motive at all or (ii) no recreational or other personal motive. In the absence of multiple motivations for an acitivity, there is obviously no need for a court to address whether the profit motive was the "primary" motive for the activity.

At one end of the spectrum are the cases cited by petitioners in which courts found that there was no profit motive whatsoever. In those cases, the courts were not required to determine whether the taxpayers had a "primary" profit motive either because the underlying transaction lacked economic substance

(*Ferguson* v. *Commissioner*, 29 F.3d 98, 102 (2d Cir. 1994)) or because the taxpayers lacked an "actual and honest" or "bona fide" profit motive (*Hendricks* v. *Commissioner*, 32 F.3d 94, 97 (4th Cir. 1994); *Burger* v. *Commissioner*, 809 F.2d 355, 358 (7th Cir. 1987); *Osteen* v. *Commissioner*, 62 F.3d 356, 358 (11th Cir. 1995)).[2]

At the other end of the spectrum, petitioners cite four cases in which there was no motive other than profit. In two of those cases (*Ranciato* v. *Commissioner*, 52 F.3d 23, 25 (2d Cir. 1995); *Cornfeld* v. *Commissioner*, 797 F.2d 1049, 1053 (D.C. Cir. 1986)), the courts made an explicit finding that there was no amusement or pleasure motive.[3] In the remaining two (*Evans* v. *Commissioner*, 908 F.2d 369, 374 (8th Cir.

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[2] Indeed, in *Hendricks* v. *Commissioner*, *supra*, the Fourth Circuit expressly endorsed the "primary" profit motive standard. The court cited its own earlier decision in *Antonides* v. *Commissioner*, 893 F.2d 656, 659 (4th Cir. 1990), and also this Court's decision in *Groetzinger*, in holding that "an expense is not deductible under Section 212 unless the taxpayer enters into the transaction in which the expense is incurred primarily for profit." 32 F.3d at 97 n.6.

[3] In *Ranciato*, the Second Circuit noted that "if the possibility that petitioners performed these labors for pleasure is eliminated, the only remaining motivation is profit." 52 F.3d at 28. Similarly, in *Cornfeld*, the District of Columbia Circuit distinguished the facts of that case from the "large class of cases where profit objective is reasonably placed in doubt because the taxpayer derives an intangible personal benefit from the purported business." 797 F.2d at 1052. The court stated in *Cornfeld* that "taxpayer's aircraft charter activities were not a hobby masquerading as a business," taxpayer was "not a pilot or skydiver," did not "amuse himself by collecting airplanes" and that "[n]othing in the record suggests that taxpayer bought this jet as a personal plaything." *Ibid.*

1990); *Smith* v. *Commissioner*, 937 F.2d 1089, 1095 (6th Cir. 1991)), there is an implicit assumption that there was no amusement or pleasure motive, for those cases involved taxpayers who were engaged in *passive* tax-sheltered investments that implicate no recreational or hobby activity.[4] See also *Peat Oil and Gas Associates* v. *Commissioner*, 100 T.C. 271, 284-286 (1993) (Swift, J., concurring) ("the primary profit-objective test should only apply when distinguishing between a hobby and a trade or business activity" and "should not apply generally to typical passive, tax-sheltered investments that are structured largely on the basis of the extensive tax benefits that Congress has made available.").

There is thus no conflict among the circuits or other reason to warrant further review of the decision in this case.

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[4] The Sixth Circuit expressly endorsed the "primary" profit motive standard in *Hayden* v. *Commissioner*, 889 F.2d 1548 (6th Cir. 1989). The court stated in that case that "[t]he threshold inquiry in determining whether an activity is a trade or business or is carried on for the production of income is whether the activity is engaged in for the *primary* purpose and *dominant* hope and intent of realizing a profit." 889 F.2d at 1552 (emphasis added).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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